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Chief Administrative Officer

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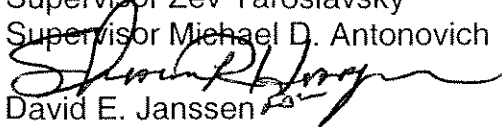
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November 17, 2004

To: Supervisor Don Knabe, Chairman
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Zev Yaroslavsky
Supervisor Michael D. Antonovich
From: 
David E. Janssen
Chief Administrative Officer

SACRAMENTO UPDATE

Today, the Legislative Analyst's Office (LAO) released its **California Fiscal Outlook, FY 2004-05 through FY 2008-09**. The LAO projects that the year-end reserves for the current year will increase by approximately \$1.2 billion to \$2 billion overall. The fiscal outlook over the next five years is not so positive.

Since the FY 2004-05 budget was adopted, revenues have increased by \$2.4 billion over FY 2003-04 and FY 2004-05 combined, fueled by a sharp increase in the corporate income tax and modest gains in both the personal income and sales taxes. These increases were slightly offset by declines in tribal gaming revenues and other non-tax sources resulting in a net increase in General Fund revenues of \$2.1 billion. On the expenditure side, costs have increased almost \$900 million according to the LAO. The primary factors driving these increases have been corrections, Medi-Cal, trial court funding, and State operations. In some cases, the estimates of savings from various budgetary solutions are falling short of expectations.

The LAO indicates that the budget for FY 2005-06 could be balanced on the basis of a strengthening revenue outlook, the use of the remaining \$3.5 billion in authorized Deficit Reduction Bonds, and a "relatively modest amount of hard choices to reduce spending and/or augment revenues." The LAO strongly cautions, however, that this approach is

only temporary because it relies on an improving carry-over balance and a number of limited solutions that were enacted as part of the FY 2004-05 budget that will not be available in subsequent budgets. **As a consequence, The LAO forecasts an operating shortfall of \$7.3 billion in FY 2005-06 that will approach nearly \$10 billion in FY 2006-07 under current law.**

Future shortfalls are dependent on a number of factors including the adoption of ongoing solutions and the level of Proposition 98 spending. The increase in projected revenues also potentially raises the Proposition 98 funding guarantee through increased spending. Thus, future operating deficits increase to nearly \$10 billion in FY 2006-07, remaining at slightly below \$9 billion until the end of the forecast period when the deficit declines to below \$6 billion. If the minimum guarantee is lower, then the operating deficits would be reduced by almost \$2 billion annually.

The structural shortfalls continue because many of the State's budget solutions have involved a number of one-time solutions. The FY 2004-05 budget contained almost \$6 billion of limited solutions including use of deficit bond proceeds, Proposition 42 transportation funds, diversion of local property taxes, pension obligation bond proceeds, and postponement of local mandate payments. The LAO also notes that its forecasts do not assume funding for the Governor's higher education compact because the Legislature has not taken any action to implement the agreement. The compact would add over \$500 million in expenditures annually by the end of the forecast period. In addition, the LAO does not assume annual transfers to the Budget Stabilization Account beginning in FY 2006-07 as required under Proposition 58, which was adopted by the voters in March 2004. The amount would be approximately \$875 million in FY 2006-07, increasing to about \$2.9 billion for FY 2008-09.

The LAO recommends four basic budget "building blocks" to consider in dealing with the FY 2005-06 budget operating shortfall. They are:

- Avoid using the remaining \$3.5 billion in Deficit Reduction Bonds in FY 2005-06.
- Avoid making additional deferred spending or revenue commitments.
- Consider maintaining FY 2004-05 Proposition 98 appropriations at the existing level.
- Adopt other ongoing budget solutions.

According to the LAO, some potential ongoing solutions include suspension or reduction of cost-of-living adjustments, reduction of General Fund support for transportation, and elimination of selected mandates and tax expenditures.

The **Fiscal Outlook** is available on the LAO's web site at www.lao.ca.gov.

Each Supervisor
November 17, 2004
Page 3

We will continue to keep you advised.

DEJ:GK
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c: Executive Officer, Board of Supervisors
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 Legislative Strategist
 Coalition of County Unions
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 Independent Cities Association
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